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No. 98-135

In the Supreme Court of the United States

OCTOBER TERM, 1997

DAVID E. MORGAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, on the particular facts of this case, petitioner is liable for the negligence penalty imposed by Section 6653(a) of the Internal Revenue Code, 26 U.S.C. 6653(a)(1982).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-2a) is unreported. The opinion of the United States Tax Court (Pet. App. 5a-62a) is unofficially reported at 72 T.C.M. (CCH) 524.

JURISDICTION

The order of the court of appeals was entered on March 9, 1998. On June 3, 1998, Justice Kennedy extended the time for filing a petition to and including July 23, 1998. The petition for a writ of certiorari was filed on July 22, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Section 6653(a) of the Internal Revenue Code imposes a penalty of five percent on any tax underpayment resulting from the "negligence" of the taxpayer. 26 U.S.C. 6653(a)(1982). The courts below concluded that, on the particular facts of this case, petitioner was negligent in the underpayment of his tax obligations.

1. a. On his income tax returns for 1978, 1980, 1981, and 1982, petitioner improperly claimed income tax deductions and credits from participation in a tax shelter scheme involving a limited partnership known as Plymouth Leasing Associates (Pet. App. 8a). That partnership was formed to promote the plastics recycling tax shelter scheme described in *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) 2531 (1992), aff'd mem., 996 F.2d 1216 (6th Cir. 1993), cert. denied, 510 U.S. 1163 (1994).

This tax shelter scheme involved a series of simultaneous sales, leases and licenses of machines designed to recycle plastic scrap (Pet. App. 11a). In 1981, Packaging Industries, Inc., manufactured and sold seven recyclers to ECI Corp. for $981,000 each. ECI Corp. then resold the recyclers (receiving primarily nonrecourse notes) to F & G Corp. for $1,162,666 each. F & G Corp. then leased the recyclers to Plymouth, which licensed them to FMEC Corp. That corporation then completed the circle by sublicensing the recyclers back to their original manufacturer, Packaging Industries, Inc. The monthly payments required among the entities involved in these transactions precisely offset each other—no cash changed hands (*id.* at 11a-12a).

The prospectus for the tax shelter scheme contained direct warnings of the tax risks presented by these sham transactions (Jt. Exh. 2-B at 2):

> AN INVESTMENT IN THE PARTNERSHIP INVOLVES A HIGH DEGREE OF BUSINESS RISK AND SOME TAX RISKS AND SHOULD, THEREFORE, BE CONSIDERED ONLY BY PERSONS WHO * * * CAN AFFORD TO LOSE ALL OF THEIR CASH INVESTMENT AND SOME OF THEIR ANTICIPATED TAX BENEFITS.

The prospectus emphasized that the partnership had no operating history and that there was no established market for the recycling machines (Pet. App. 14a, 39a). As the trial court stated (*id.* at 40a):

> A careful consideration of the materials in the offering memoranda * * * should have alerted a prudent and reasonable investor to the questionable nature of the promised deductions and credits. * * * According to the offering memoranda, for each $50,000 investor, the projected first-year tax benefits were investment tax credits in excess of $82,500 plus deductions in excess of $40,000. * * * As a result of his $50,000 investment, Morgan claimed a $40,554 operating loss and $82,526 in investment tax and business energy credits for taxable year 1981. The direct reductions * * * from the investment tax credits alone, ranged from 165 percent to 167 percent of the[] cash investment[].

The prospectus directly warned participants that, in view of the sizeable tax benefits claimed, the Internal Revenue Service would probably audit the income tax

returns of the partnership and its partners (*id.* at 14a, 39a-40a).

A tax opinion prepared by an attorney was attached to the prospectus (Pet. App. 39a). The attorney acknowledged that he lacked a technical background and did not have a good understanding of engineering or of the development and design of the recycling machine (Doc. 31, at 317). His tax opinion was addressed to the general partner of Plymouth, Richard Roberts. The opinion stated that it was for the "individual guidance" of Mr. Roberts and that investors should rely on their own advisors (Pet. App. 42a).[1] As the attorney explained at trial, his opinion "never passed on the fair market value of * * * the machine" (Doc. 31 at 318). The tax opinion merely cited "[t]he written evaluation of the Sentinel Recyclers furnished to the Partnership by one Evaluator [who] concludes that the purchase price to be paid by F & G therefor is fair and reasonable" (Jt. Exh. 2-B, App. E at 21).[2] Although the attorney concluded that the tax benefits sought by the

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[1] The prospectus similarly warned participants that the tax opinion was prepared for the general partner and that they should consult their own professional advisers (Pet. App. 41a-42a).

[2] The evaluator referenced in the attorney's opinion was Stanley M. Ulanoff, a Professor of Marketing at the School of Business of the City University of New York (Jt. Exh. 2-B, App. F). His "evaluation" consisted primarily of a discussion of the need for plastics recycling. He did not do a marketing analysis and did not analyze the costs of or anticipated revenues from the recycler. Indeed, he did not refer in his "evaluation" to the ostensible purchase price ($1,162,667) of the recycler involved in this tax shelter scheme and, so far as can be determined from reviewing his report, was unaware of it. Another purported "evaluator" was a mathematics professor named Samuel Z. Burstein. He concluded only that the equipment was operationally reliable and did not purport to determine its value (Jt. Exh. 2-B, App. F).

Partnership would probably be achieved, his opinion emphasized that "the Service is not bound by and may challenge the conclusions reached in such report" (*ibid.*).

b. Petitioner is an engineer and a geologist. He received a B.S. degree with specialization in petroleum engineering in 1939 from the Massachusetts Institute of Technology and a graduate degree in geology in 1940 from Columbia University (Pet. App. 20a-21a). He has worked for several companies, including Dresser Industries, where he was in charge of machinery for the production of warheads for half-ton bombs during World War II (*id.* at 21a).

When the war ended, petitioner went into business for himself. He owned and operated Peerless Precision Products Co. in Pawtucket, Rhode Island, which specialized in making components, assemblies, and subassemblies for aircraft engine manufacturers. He also organized and syndicated oil and gas ventures in Texas, Oklahoma, and New York State. Before proceeding with any oil drilling venture, petitioner hired a geologist to assess the potential for oil extraction (Pet. App. 21a).

Petitioner learned of the plastics recycling tax shelter either from the general partner of Plymouth (Roberts) or from another acquaintance. Before investing in the shelter, petitioner reviewed the prospectus and discussed it with a friend and also with Stuart A. Becker, an accountant and tax specialist (Pet. App. 15a-16a, 21a-22a).[3] Between 1980 and 1982, approxi-

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[3] Petitioner testified that he also sent the prospectus to his accountant to examine. He did not state, however, whether his accountant gave him any advice regarding the potential investment (Doc. 27, at 23).

mately 60% of the practice of Becker's accounting firm involved tax-advantaged investments (*id.* at 16a). During 1981, Becker investigated the plastics recycling tax shelter. He reviewed the offering memorandum and visited the plant where the recyclers were made in Hyannis, Massachusetts (*id.* at 16a-17a). Becker, who did not have an engineering background and was not an expert in plastics materials or plastics recycling, did not hire experts in these fields to advise him (*id.* at 15a, 17a).

Petitioner's meeting with Becker lasted no more than thirty minutes (Pet. App. 21a). Becker informed petitioner of the limited scope of his investigations into the plastics recycling tax shelter scheme (*id.* at 17a, 21a-22a, 30a, 38a). As Becker testified (*id.* at 38a):

> I don't recall saying to a client I did due diligence * * * [Rather,] I told [my clients] precisely what I had done to investigate or analyze a transaction. I didn't just say I did due diligence, and leave it open for them to define what I might or might not have done.

Petitioner did not make an independent investigation of the value placed on the recyclers (Pet. App. 22a, 38a). Although he lived only a short distance from Hyannis, where the recyclers were manufactured, and had been to Hyannis many times, he did not visit Packaging Industries or see a recycler prior to investing.

2. Petitioner, who had a gross income of $296,876 in 1981, claimed tax credits of $82,526 and operating losses of $40,554 arising from his $50,000 investment in the recycling tax shelter scheme in that year (Jt. Exh. 1-A; Pet. App. 40a). Because he was unable fully to utilize the tax credits in 1981, he carried the unused portion back to 1978 and 1980 (*id.* at 8a). In 1982, he claimed

losses of $1,128 arising from the tax shelter (Jt. Exh. 1-A). The investment tax credits were based on an alleged value of $1,162,666 per recycler (Pet. App. 42a). Even setting aside the other claimed tax benefits from the recycling tax shelter, the investment tax credits alone constituted an immediate return of at least 165% of petitioner's cash investment in the scheme (*id.* at 40a). The Commissioner disallowed the claimed tax benefits and asserted that petitioner was liable for penalties for negligence (26 U.S.C. 6653 (1982)) and for valuation overstatement (26 U.S.C. 6659 (1982)).

3. Petitioner sought review of the Commissioner's determinations in Tax Court. Prior to trial, he stipulated that the tax shelter transaction lacked economic substance and that the fair market value of a recycler in 1981 did not exceed $50,000 (Pet. App. 24a-25a, 42a). He therefore conceded that he was not eligible for the operating loss deductions and tax credits claimed on his returns (*id.* at 9a). He continued to assert, however, that he was not liable for the negligence penalty for claiming these improper deductions and credits.

The Tax Court sustained the imposition of the negligence penalty and rejected petitioner's assertion that he had reasonably relied on expert advisors to determine the value of the recyclers (Pet. App. 25a-47a).[4] The court concluded that the express warnings in the prospectus concerning tax risks and the implausibly disproportionate tax benefits of the shelter scheme would have alerted any prudent investor to the questionable nature of the project (*id.* at 39a-41a). The court further stated that petitioner's alleged expectation of economic profit was "incredible" due to his

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[4] The courts below also sustained the imposition of the Section 6659 penalties. Petitioner does not challenge that determination.

"inadequate investigation of the Partnership transactions, especially when compared to the care and effort [he] put into [his] oil drilling ventures" (*id.* at 28a). The court concluded that any reliance by petitioner on Becker would have been unreasonable because petitioner was "technologically and financially sophisticated" (*id.* at 38a) and "possessed the engineering and financial intellect, skills, experience, and resources to investigate properly the viability of the Plastics Recycling transaction either [himself] or by employing an independent, qualified expert" (*id.* at 37a).

4. The court of appeals affirmed (Pet. App. 1a-2a). In a brief, unreported decision, the court of appeals concluded that the Tax Court "did not clearly err in finding Petitioner negligent" (*id.* at 2a).

ARGUMENT

The petition in this case presents the same factual questions concerning the negligence of a taxpayer who participated in the plastics recycling tax shelter that are presented in *Bennett* v. *Commissioner*, 131 F.3d 130 (2d Cir. 1997) (Table), petition for cert. pending, No. 97-1717, and *Spears* v. *Commissioner*, 131 F.3d 131 (2d Cir. 1997) (Table), petition for cert. pending, No. 97-1733.[5] Here, as in *Bennett* and *Spears*, the Tax Court's finding of negligence, affirmed by the court of appeals, depended on a number of factual determinations. The Tax Court did not hold, as petitioner erroneously asserts (Pet. 12), that the negligence penalty was imposed solely because the taxpayer's advisers were not experts in the particular technology underlying the investment. Instead, the court held that petitioner

[5] Copies of the briefs filed in opposition to the petition for a writ of certiorari in those cases have been supplied to counsel for petitioner in this case.

could not reasonably have relied on Becker, his ostensible advisor, because of (i) Becker's lack of expertise in plastics and his failure to hire persons who were actually expert in this field; (ii) Becker's failure to verify the value of the recycler; (iii) Becker's reliance on biased representations of various interested persons; (iv) petitioner's knowledge of Becker's lack of technical expertise and of the limitations of Becker's investigation; and (v) petitioner's technological and financial sophistication, which enabled him to determine the viability of the plastic recycling transaction by himself or by employing an expert (Pet. App. 33a-39a). The Tax Court also emphasized that the prospectus, which was replete with warnings of business and tax risks, should have alerted petitioner to the questionable nature of the extraordinary tax benefits projected by the tax shelter scheme (*id.* at 39a-41a).

For the reasons set forth in detail in the briefs filed in opposition to the petitions for writs of certiorari in *Bennett* and *Spears*, review of these factual determinations "concurred in by two lower courts" is not warranted.[6] See, *e.g.*, *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985), quoting *Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982).

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[6] There is no merit to petitioner's assertion (Pet. 12) that the recent decision of the Fifth Circuit in *Streber* v. *Commissioner*, 138 F.3d 216 (1998), conflicts with the decision below. *Streber* did not involve a tax shelter and did not present the question whether the negligence penalty can be imposed when a taxpayer relied on advisers who were not expert in the particular technology underlying the taxpayer's investment. The issue in *Streber* was whether taxpayers who hired a lawyer to advise them of their tax liability were negligent when they followed the course of action their lawyer recommended to place them "on [a] sound legal footing." *Id.* at 219.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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